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In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 570

ALBERT GORDON MACRAE AND SHEILA MACRAE,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 26–45; Pet. 40–56) is reported at 34 T.C. 20. The opinion of the Court of Appeals (Pet. 57–63) is reported at 294 F. 2d 56.

JURISDICTION

The judgment of the Court of Appeals was entered on August 28, 1961. (Pet. 39.) The petition for a writ of certiorari was filed on November 24, 1961. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the courts below erred in holding that so-called payments of interest on so-called loans for the purported purchase and carrying of United States Treasury Notes and Federal Land Bank Bonds did not represent "interest * * * on indebtedness" within the meaning of Section 23(b) of the Internal Revenue Code of 1939 and consequently were not deductible in the computation of the taxpayers' net income.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.
>
> * * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

STATEMENT

The facts of this case involve a plan devised by a firm of brokers and dealers in securities the principal purpose of which is to create sizeable "interest" deductions for high-bracket taxpayers. (Pet. 59.)

The taxpayer[1] is a well-known entertainer. Prior to 1952, he had made no substantial investments in securities. His business and financial matters were handled for him by his attorneys. (Pet. 40–41; R. 27.)

In December 1952 B. Gerald Cantor, president of Cantor, Fitzgerald & Company, Inc. (hereinafter called "C-F"), brokers and dealers in securities, discussed with the taxpayer's attorneys the possibility that some of the latter's clients might purchase substantial face amounts of United States Treasury Notes with a minimal down payment, using borrowed funds for the bulk of the purchase price. Shortly thereafter, one of the taxpayer's attorneys advised him that he could purchase one million dollars in Treasury notes primarily with borrowed money and that the interest on the loan would be a "good tax deduction." The taxpayer was further advised that a profit reportable as a capital gain was possible and that the loan could be made on a nonrecourse basis. The taxpayer did not seek further details. He did not know nor did he inquire as to the interest rate required on the loan, the rate of return on the Treasury notes, or the possibility of profit or loss on the entire transaction apart from tax considerations. His principal purpose in agreeing to the transaction was the creation of a deduction for tax purposes. (Pet. 41; R. 27–28.)

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[1] Albert Gordon MacRae is referred to hereinafter as the taxpayer, his wife being a party only because joint returns were filed for the taxable years (1952 and 1953).

On December 19, 1952, with settlement date of December 26, the taxpayer placed with C-F an order to purchase for his account 1⅜ per cent Treasury notes, maturing March 15, 1954, in the face amount of one million dollars. The confirmation slip of C-F showed the price as $992,500 with accrued interest of $3,874.31. Thereupon the taxpayer issued a check in the amount of $3,874.31, which C-F received on or about December 26, 1952. The taxpayer also executed and delivered to C-F his promissory note in the amount of $992,500, dated December 26, 1952, and due March 15, 1954, with interest at 2½ per cent per annum. The taxpayer's note was without personal liability and was limited to the collateral security, consisting of the Treasury notes. It provided that the taxpayer might sell the Treasury notes at any time and discharge the indebtedness by payment of the net proceeds received. He might also anticipate payment by paying additional interest of ½ per cent per annum prorated to the maturity date of March 15, 1954. The note further recited that taxpayer had paid the interest, due and to be due, concurrently with the execution of the note and gave C-F a lien against the securities pledged for the principal amount of the note. C-F was to have the right to "re-hypothecate or borrow the said securities, provided however, that such re-hypothecation or borrowing shall not be inconsistent in any manner with the ownership" by the taxpayer of the securities. The taxpayer was to have the right "to obtain the return of said securities in kind at any time upon tender of payment of the principal indebtedness due" under the note. (Pet. 41–42; R. 28–29.)

C-F had no Treasury notes in inventory when the taxpayer placed his above-described order with it. On December 26, 1952, C-F went through the mechanics of both buying and selling two million dollars in such Treasury notes, which amount included the one million dollars of notes ordered by the taxpayer. At the close of business on December 26, 1952, C-F's inventory did not include any Treasury notes. (Pet. 42–43; R. 29.)

The transaction by which C-F bought and sold the Treasury notes was as follows: C-F arranged a purchase from and sale to C. F. Childs, a dealer in securities, to be effected the same day. Carl M. Loeb, Rhoades & Company, Inc., acted as clearance agent. Pursuant to instructions from C-F, Rhoades received the Treasury notes against payment to Childs, and on the same day redelivered them to Childs against payment from the latter. C-F was charged a clearance fee and any differential between the purchase and sale prices. The sale to Childs constituted a "borrowing" by C-F of the Treasury notes in accordance with the above-quoted provision of the taxpayer's note. The "borrowing" of securities is a common practice among dealers and brokers in securities. (Pet. 43; R. 29–30.)

On December 26, 1952, the taxpayer issued to C-F a check in the amount of $30,257.42, purportedly as interest to March 15, 1954. (Pet. 43; R. 30.)

On or about January 26, 1953, the taxpayer's purported loan owing to C-F was refinanced through the

Gibraltar Financial Corporation.[2] The taxpayer executed a new note under the terms of which Gibraltar was substituted for C-F as payee, the nonrecourse feature was eliminated, the interest rate was reduced from 2.5 per cent to 2.42 per cent, the amount of the "loan" was increased from $992,500 to $1,020,000 (face value of the Treasury notes plus interest coupons), and the right to a refund of a portion of interest upon prepayment was eliminated. (Pet. 45; R. 31.)

On the same day, the taxpayer issued his check to C-F, as correspondent for Gibraltar, in the amount of $27,930.11, purportedly as interest to March 15, 1954, on the new note. At the same time, he received a check from C-F in the amount of $28,082.08, as a refund of interest on cancellation of the old note. (Pet. 45; R. 31–32.)

Under the terms of the new note, the one million dollars in Treasury notes was pledged as collateral security. In accordance with this arrangement, the taxpayer directed C-F to deliver the Treasury notes to Gibraltar against payment of $1,020,000. C-F

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[2] Gibraltar was incorporated on or about December 24, 1952. Initial working capital consisted of $1,500 in borrowed money and $2,000 of capital investment paid in on December 29, 1952. No further capital was invested in Gibraltar at any time pertinent. (Pet. 43; R. 30.)

For the period December 24 to December 31, 1952, Gibraltar's records reflect loans to customers in the amount of seventeen million dollars, with another seventeen million dollars in such loans for the following month. The first such loan, in the amount of $1,020,000, is recorded as being made December 26, 1952. All "loans" listed on Gibraltar's books during the period here in issue arose through transactions similar to those of the taxpayer, as hereinafter described. (Pet. 43–44; R. 30.)

did not then have the Treasury notes, and the transfer of the Treasury notes and liability was accomplished by book entries of C–F and Gibraltar. (Pet. 45; R. 32.)

On August 12, 1953, the taxpayer purported to sell the Treasury notes to C-F at a total price of $1,001,891.98, including accrued interest in the amount of $5,641.98. The sale was accomplished by virtually simultaneous purchases and sales of identical securities by C-F and Gibraltar, through their clearance agents, in much the same manner as the initial purported purchase. (Pet. 45–46; R. 32–33.) As a result of such actions, Gibraltar and C-F were charged by their respective clearance agents with the clearance fee and the difference between the buy and sell prices. The only substantial monies or credit utilized belonged to the clearance agents, whose willingness to use their funds or credit was attributable to the fact that they held instructions to deliver as well as to receive against payment, and that, apart from the comparatively nominal clearance fee and difference between buy and sell prices, no risk existed. (Pet. 46; R. 33.)

On March 10, 1953, taxpayer entered into a similar transaction with C-F and Gibraltar for the purported purchase of Federal Land Bank Bonds in the face amount of two million dollars. Later in 1953 he made two similar arrangements with the same companies with respect to a total of two million dollars face amount of United States Treasury Notes. The purchases were carried out in the same manner as previ-

ously—by orders by C-F and Gibraltar for the purchase and sale of identical securities on the same day. In each case Gibraltar purported to withhold a substantial amount of the principal amount of the notes as security for interest, to be released as interest payments were made. Subsequent to the taxable years in issue the taxpayer closed out these transactions in essentially the same manner as described above with respect to the Treasury notes purportedly purchased in 1952. (Pet. 46–48; R. 33–35.)

The taxpayer issued to C-F, purportedly as interest payments, checks in the net amount of $30,257.42 during 1952 and $132,632.12 during 1953. These amounts were claimed as interest deductions in taxpayer's returns for 1952 and 1953. (Pet. 48–49; R. 36–37.) During 1953 the taxpayer received various amounts from C-F, both on its own and on Gibraltar's account, purportedly as interest, a refund of interest, the balance due on a sale of notes, and a refund of excess loan funds. (Pet. 49; R. 37.) Such amounts were received a few days after, and in amounts slightly smaller than, taxpayer's payments to C-F. (Pet. 48; R. 36, 146–150.) In his 1953 return taxpayer reported $34,094 as interest income, and $1,562.50 as capital gain from sale of the Treasury notes. (Pet. 49; R. 37.)

Gibraltar did not at any time have possession of any Treasury notes or Bonds, and consequently did not receive interest thereon. Its books do not reflect such interest receipts but do credit taxpayer with the amount of interest which he would have received as a holder. (Pet. 49; R. 37.)

The Commissioner disallowed the claimed interest deductions. (Pet. 40; R. 7–8, 10, 26.) The Tax Court found that the transactions in issue did not create a bona fide indebtedness but were shams, and accordingly sustained the Commissioner's determination. (Pet. 50–55.) The Court of Appeals affirmed. (Pet. 57–62.)[3]

ARGUMENT

The decision below, affirming that of the Tax Court, is controlled by and in accord with this Court's decision in *Knetsch* v. *United States*, 364 U.S. 361. There is no conflicting decision, and no other reason for further review by this Court.

1. Like *Knetsch* v. *United States, supra*, the instant case involves a plan designed to create for a high-bracket taxpayer large "interest" deductions, far in excess of his actual cash investment in the scheme. In *Knetsch* this Court held that an arrangement for the purchase of single-premium annuity bonds was a sham, that no real "indebtedness" had been created under the arrangement, and that Knetsch's purported "interest" payments were not deductible under Section 23(b) of the 1939 Code, *supra*, p. 2, and Section 163(a) of the 1954 Code.[4] The present case is

[3] Another issue, involving deductibility of taxpayer's out-of-pocket costs, was decided in his favor (Pet. 62–63) and is not presented here.

[4] So-called "interest" payments arising out of similar purported annuity contracts were held non-deductible by the courts of appeals in *Emmons* v. *Commissioner*, 270 F. 2d 294 (C.A. 3d), certiorari denied, 364 U.S. 908; *Weller* v. *Commissioner*, 270 F. 2d 294 (C.A. 3d), certiorari denied, 364 U.S. 908; *Diggs* v. *Commissioner*, 281 F. 2d 326 (C.A. 2d), certiorari denied, 364 U.S. 908; *United States* v. *Roderick*, 290 F. 2d 823 (C.A. 5th).

closely analogous, though involving purported purchases of securities issued or guaranteed by the United States. In cases involving similar sham purchases of Government securities, the courts uniformly have denied taxpayers' claims to deductions for "interest" payments where no real indebtedness has been incurred. In such cases, as in this one, the purported securities transactions were accomplished by offsetting book entries based upon virtually simultaneous purchases and sales of identical securities. See *Kaye* v. *Commissioner*, 287 F. 2d 40 (C.A. 9th) (involving arrangements by the same brokerage house which planned and executed the transactions here in issue); *Becker* v. *Commissioner*, 277 F. 2d 146 (C.A. 2d); *Lynch* v. *Commissioner*, 273 F. 2d 867 (C.A. 2d); *Goodstein* v. *Commissioner*, 267 F. 2d 127 (C.A. 1st); *Sonnabend* v. *Commissioner*, 267 F. 2d 319 (C.A. 1st); *Broome* v. *United States*, 170 F. Supp. 613 (C. Cls.).

2. In the present case the taxpayer in form "purchased" United States Treasury Notes and Federal Land Bank Bonds from a broker-dealer with "loans" from the latter and a closely-affiliated finance company at rates of interest, sometimes prepaid, one per cent or more in excess of the interest rate on the securities supposedly purchased. The short-term securities were "purchased" at relatively slight discounts.[8] The Treasury notes and the Bonds sup-

[8] The chance of making a profit from the appreciation of Treasury notes purchased with borrowed funds at the time and on the terms of taxpayer's transaction "would be very low" according to the financial expert who testified for the taxpayer. (R. 251.)

posedly were held by the finance company as security for the loans. In fact, however, the purported "purchases" of securities were handled by virtually simultaneous offsetting orders to buy and sell the same securities. Therefore, neither the finance company nor the broker-dealer ever actually held any securities. (Pet. 41–43, 46–48; R. 28–30, 33–35.) The finance company lacked sufficient funds to make actual loans of the amount it purportedly was lending to the taxpayer. (Pet. 43–44; R. 30–31.) The taxpayer never actually received the principal of the "loans" or the securities supposedly purchased with the "loans," and in fact he could not have obtained either since neither the broker nor the finance company ever had them. (Pet. 41–49; R. 28–35.) Moreover, all the "loans," except one which promptly was refinanced (Pet. 45; R. 31), were made at the par value of the securities plus the interest coupons to accrue (Pet. 45–48; R. 31–35). This enabled the finance company and the broker to refund a high proportion of the taxpayer's "interest" payments promptly in the form of a "refund of excess loan funds," as well as purported interest, refund of interest, and the balance due on a supposed sale of notes. (Pet. 47–49; R. 33–37; 146–150). Thus, whenever the taxpayer made a payment of "interest," he received shortly thereafter a refund in an amount somewhat less than his payment. Consequently the taxpayer had minimal out-of-pocket expense with respect to the large interest deductions which he claimed.

On the basis of these undisputed facts, and the principles enunciated by this Court in *Knetsch*, the

courts below were fully justified in holding that the transactions in issue did not give rise to any real indebtedness or any real payments of interest, but were shams. Taxpayer's contention (Pet. 25–33) that he personally may have been unaware of the details of the transaction, about which he had been generally informed and which he had authorized (R. 77–78), is beside the issue; the crucial fact remains that taxpayer did not actually borrow any money or purchase any securities—and did not intend to do so (Pet. 49; R. 37–38). See *Lynch* v. *Commissioner*, 273 F. 2d 867, 872 (C.A. 2d). As both courts below pointed out (Pet. 53–54, 59–60), whether or not taxpayer knew of the mechanics employed by his agent, the amounts in question are deductible as interest "only if they were in fact paid as interest on an existing indebtedness," and no true indebtedness existed. Here, as in *Knetsch* (p. 366), "there was nothing of substance to be realized by * * * [taxpayer] from this transaction beyond a tax deduction."

3. The decisions upon which taxpayer relies for conflict furnish no support whatever for his position. *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118 (C.A. 2d), upon which he chiefly relies (Pet. 13–16), did not involve the tax effect of a sham transaction, as does the instant case. It was there held that debentures issued by a subsidiary to its parent in payment of a dividend declared out of paid-in surplus—a concededly real transaction—represented a creditor (debt) rather than a proprietary (stock) interest in the subsidiary. Cf. *Gregg Co. of Delaware* v. *Commissioner*, 239 F. 2d 498 (C.A. 2d), certiorari

denied, 353 U.S. 946. The opinion is to be searched in vain for any suggestion that a sham indebtedness—the kind here involved—entitles a taxpayer to an interest deduction.[6] Indeed, the Second Circuit's *Kraft* decision is to be contrasted with the same court's decisions in *Becker* and *Lynch, supra,* which bear a close resemblance to the instant case, and in which claimed interest deductions were disallowed on the ground that no real indebtedness had been created.

As for *Gregory* v. *Helvering,* 293 U.S. 465, and like cases relied upon by taxpayers (Pet. 21–22), they confirm rather than impugn the correctness of the decision below. They stand for the familiar proposition that while a taxpayer may minimize taxes by any lawful means, he may not do so by resorting to sham transactions. See *Knetsch* v. *United States,* 364 U.S. at 365, 367.

Nor is the decision below inconsistent with *Stanton* v. *Commissioner,* 34 T.C. 1, as taxpayer contends (Pet. 19–20). In that case the taxpayer actually borrowed funds from banks and used the loan proceeds to purchase securities on the open market.[7] In the

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[6] Similarly, *Preston* v. *Commissioner,* 132 F. 2d 763 (C.A. 2d), upon which taxpayer also relies (Pet. 17), involved a real indebtedness for monies actually borrowed, not a sham loan.

[7] Taxpayer's reliance (Pet. 22) upon *Maysteel Products, Inc.* v. *Commissioner,* 287 F. 2d 429 (C.A. 7th); *Fabreeka Products Co.* v. *Commissioner,* 294 F. 2d 876 (C.A. 1st), and *Evans* v. *Dudley* (C.A. 3d), decided September 21, 1961 (8 A.F.T.R. 2d 5706), as creating a conflict also is misplaced. In those cases, involving a deduction for amortizable bond premiums, the taxpayers had actually borrowed funds, actually purchased bonds, and assumed the risks of genuine obligations. Thus the facts

present case there was no real borrowing and no real purchase of any securities by or for the taxpayer. The *Stanton* decision is consistent with the holding of the courts below that under the circumstances of this case, involving sham transactions and no actual borrowing, taxpayer did not pay any "interest * * * on indebtedness" and is not entitled to a deduction under Section 23(b).

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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DECEMBER 1961.

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are not analogous to those of the present case. Here there was no real borrowing or purchase of securities, but only a series of offsetting actions designed to create "the facade of 'loans'." *Knetsch* v. *United States*, *supra*, p. 366.